WHITHER GLOBALIZATION?

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- Over the last decade, the rise of globalization has coincided with a period of economic growth that has seen significant advances in technology, deregulation and trade.

- While there have been many winners from globalization – witness the rise of the middle class in emerging markets – there are a growing number of losers and they are making their voices heard – witness Brexit and the election of President Trump.

- The growing strength of political populism has the power to derail the smooth passage of globalization. As the political spotlight moves to continental Europe, the advance of the disenfranchised will place a lot of pressure on the financial system and impact significantly on global markets.

Globalization – the process by which commodity, capital and labor markets across the world have been opened up and meaningfully deregulated, allowing economic integration across national borders – has coincided with a period of substantial global economic growth. Trade has exploded over recent decades as tariff and non-tariff barriers have fallen, and technology has reduced distances among trade partners. Capitalists have become rich engaging in unit labor cost arbitrage, while more people based in emerging markets have exited poverty more quickly than any time in human history. And this process of globalization has coincided with a sharp decline in inflation and real bond yields – one that we believe is causally-linked.

The manner in which these economic gains have been distributed is still best-captured by the work of Branko Milanovic, best-known for his ‘Elephant chart’. Essentially, Milanovic’s work points to faster income growth among the highest earners in advanced economies and middle-income households in developing countries, with slower income growth among lower income households in the West.
The social, political and cultural implications of globalization in the West have so far been beyond the scope of our analysis. But the recent votes for Brexit in the U.K. and President-elect Trump in the U.S., as well as the rise of electorally significant anti-globalization movements across Europe bring alive these considerations when thinking about prospective policy. As such, it is not easy to invest without taking a view as to how these trends will develop.

Associating President Trump’s election with a backlash against globalization appears intuitive. Looking at the breakdown of Republican voter support by income bracket we observe that while lower-income groups mostly voted Democrat, the swing towards the Republican Party by voters in these income brackets was the factor that delivered the Presidency to Trump. The single most important statistical variable associated with the electoral swings to both Trump in the U.S., and to Brexit in the UK, was the proportion of voters in an electoral catchment area lacking a college degree. While correlation is not causation, we observe that those without college degrees appear least well-equipped to adapt to the challenges and opportunities of globalization. The narrative that this cohort was ‘left behind’ by globalization and used the ballot box to strike back appears not without merit.

Looking to Europe we see near-term tests of the existing political order, where anti-globalization movements are being championed by the Five Star Movement in Italy, the National Front in France,
AfD in Germany, the Freedom Party in Austria and the PVV in Holland. We note that while democracy serves to diffuse tensions in most polities, the brittleness associated with monetary union in the case of the Eurozone could lead to fracture should an anti-globalization movement win power and seek to leave the Eurozone.

The combination of globalization, advances in technology and inflation-fighting central banks have hollowed out much of the middle-and-lower income occupations in European economies. Downward pressure on middle-and-lower-income occupation wages has persisted, while political leaders seeking to address the concerns of those left behind appear to have a variety of options available.

At one end of the spectrum, there is the option to better compensate these lower-income groups through some mixture of welfare and public employment programs – make-work as some call it. This has the merit of keeping alive a global economic program of economic convergence that has proved hugely successful in maximizing economic growth and development through international economic integration.

At the other end, there is the option to step back from globalization and towards autarky (economic self-sufficiency), either within national boundaries or within regional blocs of countries with similar domestic political concerns. This has the merit of keeping less-skilled domestic workforces in productive employment, although this strategy is still vulnerable to technological progress and is typically associated with stagnant living standards (as the aggregate economic gains of international economic integration are no longer taken).

From an investment perspective, the implications of such a tectonic shift away from greater economic integration are profound. The secular fall in world real interest rates that has boosted the valuation of future cash-flows appears to us related to global economic integration. This has delivered a constructive investment environment not only for high returns from bond markets but also equity and property markets.

While top-line revenues of labor-intensive firms will benefit from reflationaly policies (associated with larger budget deficits and a move away from globalization), the lack of labor slack in developed markets means that it is unlikely that we will see profitability rise proportionately as these same policies appear likely to accrue pricing power to labor. That said, firms with high levels of operational leverage would likely benefit, and firms with both high financial leverage and no near-term financing needs would profit from the money illusion that reflaction delivers.

Economically, a move away from free trade and towards autarky at a national or regional level would leave all parties worse off at an aggregate level. It would erect barriers to emerging market economic development, as reshoring removes opportunities for the growth of relatively well-paid employment in emerging markets. Trade accounts for a significant proportion of most emerging market economies, meaning that there is the potential for significant disruption in many economies.

We will not know for some time whether the de-globalization train has been set inexorably in motion. But the implications of this move from an investment perspective appear profound.
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